

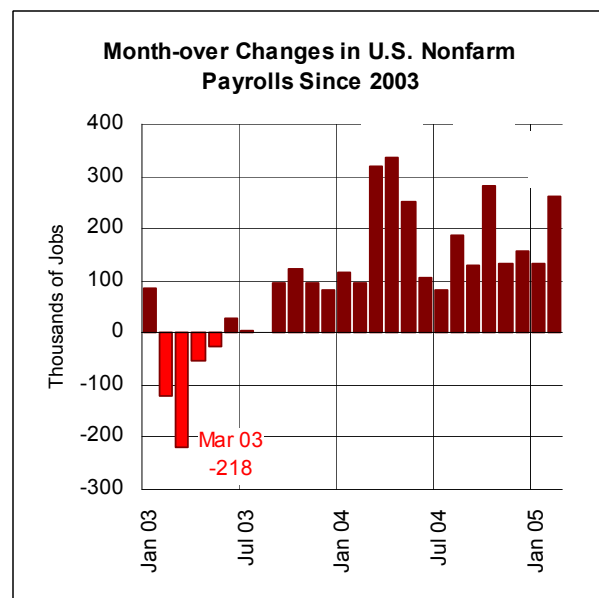
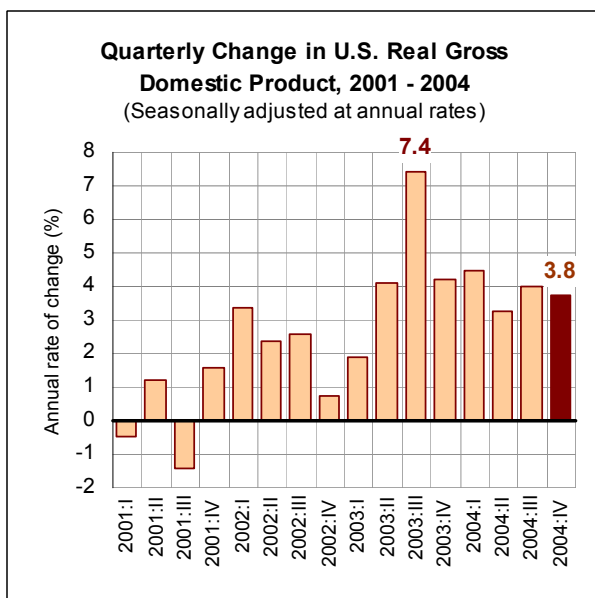
## Economic Update

LMID Advisory Group Meeting

March 7, 2005

### I. U.S. Economy

The U.S. economy is humming along at a good pace. As seen in the left hand chart below, real gross domestic product (GDP) grew at an annualized pace of 3.8 percent in the fourth quarter of 2004. This marked the seventh consecutive quarter of real GDP growth of 3.0 percent or more, and sixth time in the last seven quarters that GDP has grown at a pace approaching 4.0 percent (or more). U.S. GDP grew by 4.4 percent in 2004, which was the second strongest year of economic growth the U.S. has had since 1984.



U.S. job growth has also been quite healthy. As seen in the right hand chart above, U.S. payrolls grew by 262,000 jobs in February, marking the 21st consecutive month of nonfarm payroll growth. Since August 2004, the U.S. nonfarm payrolls have grown by nearly 3 million jobs, or at an average pace of 166,000 jobs per month. Over the last year alone, the U.S. economy has added nearly 2.4 million jobs, growing at an average pace of 198,000 jobs a month. In other words, the U.S. economy has been generating jobs at a rate that matches the 150,000 to 200,000 jobs economists reckon are needed every month to keep pace with the expanding labor force.

Wall Street optimists couldn't have been happier with this recent economic news. The GDP data indicate that the economy has found a sustainable – and strong -- growth pace of between 3.5 and 4.0 percent. Moreover, the jobs data indicate that this rate of economic growth will generate a balanced rate of job growth – rapid

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enough to lower unemployment and raise incomes and sustain spending, but not rapid enough to exert the undue upward pressure on wages that might kindle inflation. Given that businesses are flush with profits, conditions are ripe for business-led expansion.

What could be wrong with this rosy outlook? The California Department of Finance (DOF) worries that 2004 will be as good as the U.S. economy will get. DOF believes the U.S. economy is likely to cool down in the next two years, forecasting GDP growth of 3.3 percent in 2005 and 3.0 in 2006. This cooling will be due to a combination of: rising interest rates that will dampen consumer spending; the expiration of bonus depreciation policies that will slow capital investment; and residential construction that will likely slip after having its best year since 1978. Moreover, the U.S. government has no more room to stimulate the economy with fiscal policies such as tax cuts.

The UCLA Anderson School is even more pessimistic than DOF, predicting U.S. GDP growth of 3.1 percent in 2005, and 2.5 percent in 2006. More worrisome, in UCLA's opinion, is a growing likelihood of a consumer-led recession. The current economic expansion is now 13 quarters old. Only four post-WWII expansions have lasted longer than 20 quarters, and each of these was extended by extraordinary events. No such unusual events are on the horizon today. Budget deficits preclude stimulatory fiscal policies or increased government spending. The housing sector can't provide a stimulus to the economy because spending on housing is already at record levels. Business investment is also at a high level and unlikely to provide a stimulus. Exports provide a ray hope, but likely can't grow enough to extend the recovery.

Instead, rising interest rates threaten to choke off consumer spending and burst the housing bubble. Housing and consumer spending are cyclical. However, the last economic downturn was caused by a downturn in business investment. The housing market, boosted by record low interest rates, remained strong and is now showing signs of overheating. The sector is overdue for an adjustment, and rising interest rates will only cool the market. This directly threatens consumer spending, which has been fueled by borrowing against rising home values (and readily available credit from credit card companies). The problem is that consumers have been spending wealth that is not real – the only way to realize higher home prices is to sell one's house, but if everybody sells, prices will plunge. Rising interest rates and debt burdens threaten not only to cut off the fuel for future spending, but to cut spending. Far from being in a "vigorous youth" cycle, the housing and consumer sectors are showing signs of advanced age.

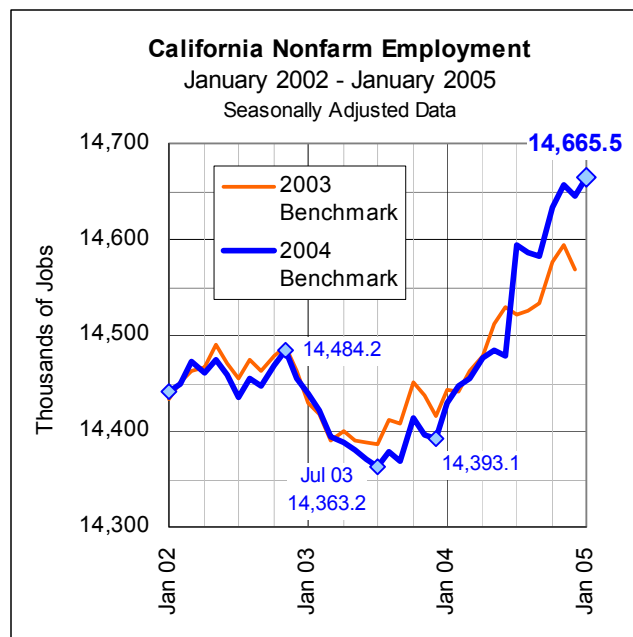
Things aren't much better on the government side. A handful of Asian countries – most notably China and Japan – are currently financing the U.S. current accounts and trade deficits. If these countries were to shift their investment elsewhere (i.e., into Euros), interest rates in the U.S. would certainly spike.

## II. Nonfarm Payroll Employment

The California economy is also showing signs of strength. Personal income is rising and taxable sales are up. According to the Legislative Analyst's Office (LAO), there is a ray of hope that the State budget crisis might be manageable – provided appropriate steps are taken to address it. On the employment front, “as goes the Nation, so goes California.”

California industry employment data have been benchmarked to 2004 levels. The benchmark revisions this year were very minor in comparison to past years, but nevertheless affected recent employment trends.

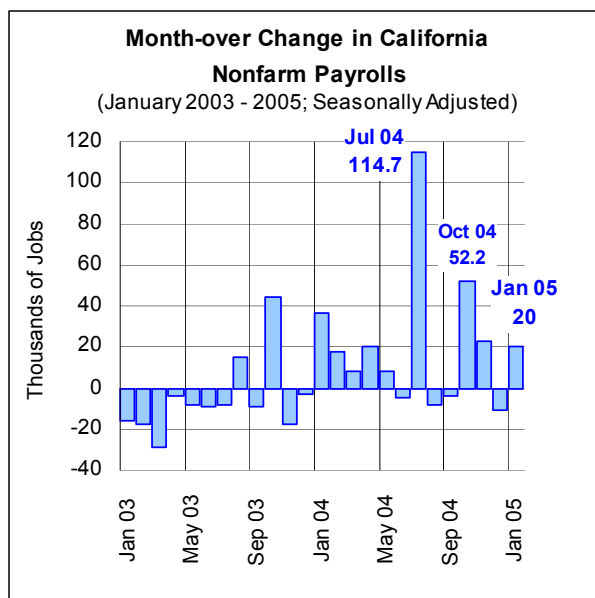
The chart below shows the three-year trend in California nonfarm employment. The blue line depicts the revised 2004 benchmark employment trend, while the orange line shows the pre-benchmark trend. The chart shows that California's employment growth since July 2003 was stronger than first estimated. However, the State's job losses in the first half of 2003 were larger than originally estimated.



California lost 121,000 jobs from November 2002 through July 2003, an average loss of 15,100 jobs a month. From its low point in July 2003 through January 2005, the California economy added 302,300 jobs. Job growth accelerated in 2004. From December 2003 through January 2005, California nonfarm payrolls grew by 272,400 jobs, or by an average of 21,000 jobs a month.

The chart at the top of the next page shows month over-change California's nonfarm payrolls over the last two years. The revised employment series shows an unusually large 114,700-job gain in July 2004. This was California's largest one-month job increase dating back at least to January 1990.

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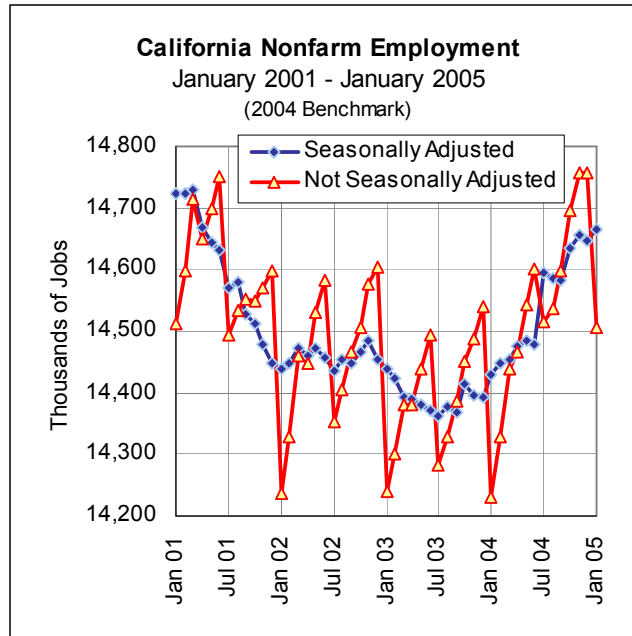


The seasonal adjustment process magnified the July 2004 job gain. Following are the unadjusted, month-over change in the number jobs over the past six Julys.

July 2004:	-85,500 jobs
July 2003:	-211,500 jobs
July 2002:	-228,700 jobs
July 2001:	-257,900 jobs
July 2000:	-149,800 jobs
July 1999:	-61,500 jobs

The seasonal adjustment process covers a ten-year period, with greater weight given to the last five years and progressively greater weight given to recent years. The not seasonally adjusted job loss in July 2004 was a fraction of the July losses of the previous four years, and more particularly, the previous three. This implies that the seasonal adjustment process, by predicting a much larger job loss than actually occurred, boosted seasonally adjusted employment in July 2004 by an unusually large degree.

Although the seasonally adjustment process may have accentuated the size of the July 2004 job gain, it did not affect the longer-term trend of employment growth. This is seen in the chart at the top of the next page, which shows seasonally adjusted and not seasonally adjusted nonfarm employment in California over the last four years. Both the seasonally adjusted and not seasonally adjusted series show accelerated job growth over the last year.

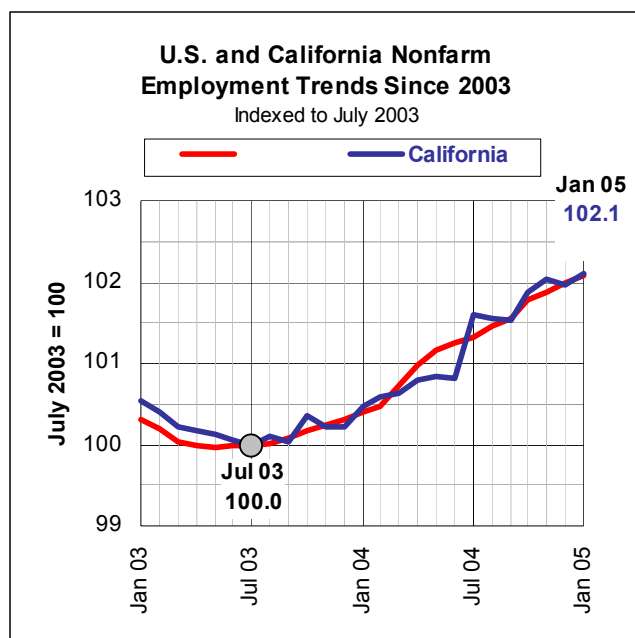


As noted previously, California payrolls grew by 272,400 jobs from December 2003 through January 2005. The job growth trend over these 13 months can be broken down as follows.

January 2004 – May 2004:	91,000 jobs gained; 18,200 jobs per month.
June 2004 – September 2004:	97,300 jobs gained; 24,300 jobs per month.
October 2004 – January 2005:	84,100 jobs gained; 21,000 jobs per month.

California's employment growth in recent months has more or less paralleled the nation's. U.S. nonfarm payrolls rose for the 20<sup>th</sup> consecutive month in January, growing by 146,000 jobs. California's share of this monthly gain was 13.7 percent. Year-over, U.S. nonfarm payrolls grew by 2,201,000 jobs, or 1.7 percent. This compares to a year-over gain of 235,800 jobs, or 1.6 percent, in California. California's share of the year-over job gain was 10.7 percent.

The chart at the top of the next page compares U.S. and California employment trends over the last three years. Employment is indexed to July 2003 levels. This month marked the beginning of California's ongoing turnaround in employment. U.S. nonfarm payrolls grew by 2.1 percent from July 2003 through January 2005. California had identical 2.1 percent over the same period.



#### IV. Industry Trends

The following table summarizes the change in California industry employment in January 2005, compared to month-ago and year-ago levels.

**California Nonfarm Payroll Employment by Industry Sector**  
(Thousands of Jobs, Seasonally Adjusted)

MAJOR SECTOR	YEAR AGO	MONTH AGO	CURRENT	MONTH-OVER CHANGE		YEAR-OVER CHANGE	
	Jan 04	Dec 04	Jan 05	Number	Percent	Number	Percent
		<i>Revised</i>	<i>Preliminary</i>				
Total Nonfarm	14,429.7	14,645.5	14,665.5	20.0	0.1%	235.8	1.6%
Natural Res. & Mining	23.0	23.2	22.9	-0.3	-1.3%	-0.1	-0.4%
Construction	821.6	870.3	870.8	0.5	0.1%	49.2	6.0%
Manufacturing	1,532.0	1,535.1	1,538.3	3.2	0.2%	6.3	0.4%
Trade, Transp. & Utilities	2,723.5	2,778.9	2,773.4	-5.5	-0.2%	49.9	1.8%
Information	485.6	479.1	476.3	-2.8	-0.6%	-9.3	-1.9%
Financial Activities	894.1	916.4	917.8	1.4	0.2%	23.7	2.7%
Profess. & Business Serv.	2,069.5	2,130.4	2,131.9	1.5	0.1%	62.4	3.0%
Educational & Health Serv.	1,552.0	1,571.1	1,574.8	3.7	0.2%	22.8	1.5%
Leisure & Hospitality	1,428.0	1,454.0	1,468.8	14.8	1.0%	40.8	2.9%
Other Services	503.7	506.2	507.3	1.1	0.2%	3.6	0.7%
Government	2,396.7	2,380.8	2,383.2	2.4	0.1%	-13.5	-0.6%

Data may not add due to rounding.

Source: EDD, Labor Market Information Division, Current Employment Statistics (CES) Program.

Eight sectors showed year-over job gains in January, while three showed losses. Professional and business services (62,400 jobs) had the largest job increase. Industries with year-over gains of more than 40,000 jobs were: trade, transportation, and utilities (49,900 jobs); construction (49,200 jobs); and leisure and hospitality (40,800 jobs). Financial activities (23,700 jobs) and educational and health services (22,800 jobs) were the other industries to gain more than 20,000 jobs.

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On a relative basis, construction (6.0 percent) was California's fastest growing sector over the last year. Industries with year-over growth of greater than 2.5 percent were: professional and business services (3.0 percent), leisure and hospitality (2.9 percent), and financial activities (2.7 percent). Trade, transportation, and utilities (1.8 percent) was the the only other sector to exceed the economy-wide year-over growth rate of 1.6 percent.

Government continued be California's weakest industry sectors in absolute year-over comparisons. Year-over government losses totaled 13,500 jobs in January. Information (9,300 jobs) and natural resources and mining (100 jobs) were the other sectors to have year-over job losses. On a relative basis, information (1.9 percent) had the steepest year-over job loss, followed by government (0.6 percent) and natural resources and mining (0.4 percent).

The following table summarizes the change in California industry employment in January 2005, compared to month-ago and year-ago levels.

**U.S. Nonfarm Payroll Employment by Industry Sector**  
(Thousands of Jobs, Seasonally Adjusted)

MAJOR SECTOR	YEAR AGO	MONTH AGO	CURRENT	MONTH-OVER CHANGE		YEAR-OVER CHANGE	
	Jan 04	Dec 04	Jan 05	Number	Percent	Number	Percent
		<i>Preliminary</i>	<i>Preliminary</i>				
Total Nonfarm	130,372	132,427	132,573	146	0.1%	2,201	1.7%
Natural Res. & Mining	575	602	605	3	0.5%	30	5.2%
Construction	6,845	7,074	7,065	-9	-0.1%	220	3.2%
Manufacturing	14,283	14,330	14,305	-25	-0.2%	22	0.2%
Trade, Transp. & Utilities	25,348	25,628	25,682	54	0.2%	334	1.3%
Information	3,139	3,135	3,139	4	0.1%	0	0.0%
Financial Activities	7,989	8,127	8,148	21	0.3%	159	2.0%
Profess. & Business Serv.	16,138	16,650	16,675	25	0.2%	537	3.3%
Educational & Health Serv.	16,766	17,155	17,190	35	0.2%	424	2.5%
Leisure & Hospitality	12,351	12,580	12,600	20	0.2%	249	2.0%
Other Services	5,405	5,447	5,453	6	0.1%	48	0.9%
Government	21,533	21,699	21,711	12	0.1%	178	0.8%

Data may not add due to rounding.

Source: U.S. Bureau of Labor Statistics, "U.S. Employment Situation" News Release, Table B-1.

Five California industries had more rapid relative job growth over the last year than their national counterparts. They were: construction (California = 6 percent; U.S. = 3.2 percent); leisure and hospitality (California = 2.9 percent; U.S. = 2.0 percent); financial activities (California = 2.7 percent; U.S. = 2.0 percent); trade, transportation, and utilities (California = 1.8 percent; U.S. = 1.3 percent); and manufacturing (California = 0.4 percent; U.S. = 0.2 percent).

Three U.S. industries had more rapid relative growth than their California counterparts. They were: educational and health services (U.S. = 2.5 percent; California = 1.5 percent), professional and business services (U.S. = 3.3 percent; California = 3.0 percent), and other services (U.S. = 0.9 percent; California = 0.7 percent).

Information, government, and natural resources and mining lost jobs in California over the last year, but grew nationally – albeit marginally in the case of information.

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### IV. Area Trends

The following tables compare pre- and –post benchmark nonfarm employment trends in California’s five largest regions and selected areas over the last two years.

**Year-over Change in Nonfarm Employment in the  
Southern California Region, January 2005**

	<u>Change in Number</u>	<u>Change in Percent</u>
Southern California Region	77,800	1.1
Riverside-San Bernardino-Ontario MSA	36,700	3.3
Santa Ana-Anaheim-Irvine MSA	29,800	2.1
Oxnard-Thousand Oaks-Ventura MSA	1,600	0.6
Los Angeles-Long Beach-Glendale MSA	9,700	0.2

**Year-over Change in Nonfarm Employment in the  
Bay Area Region, January 2005**

	<u>Change in Number</u>	<u>Change in Percent</u>
Bay Area	20,700	0.6
Santa Cruz-Watsonville MSA	2,600	2.9
Vallejo-Fairfield MSA	2,000	1.7
Oakland-Fremont-Hayward MSA	10,300	1.0
San Francisco-San Mateo-Redwood City MSA	6,800	0.7
Santa Rosa-Petaluma MSA	1,100	0.6
Napa MSA	200	0.3
San Jose-Sunnyvale-Santa Clara MSA	-2,300	-0.3



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### Year-over Change in Nonfarm Employment in the Southern Border Region, January 2005

	<u>Change in Number</u>	<u>Change in Percent</u>
Southern Border Region	23,000	1.8
San Diego-Carlsbad-San Marcos MSA	22,300	1.8
EI Centro MSA	700	1.7

### Year-over Change in Nonfarm Employment in the San Joaquin Valley Region, January 2005

	<u>Change in Number</u>	<u>Change in Percent</u>
San Joaquin Valley	27,200	2.6
Merced MSA	3,300	6.1
Hanford-Corcoran MSA	1,600	5.0
Modesto MSA	5,700	3.9
Stockton MSA	6,300	3.2
Bakersfield MSA	5,300	2.6
Madera MSA	700	2.2
Fresno MSA	4,600	1.7
Visalia-Porterville MSA	-300	-0.3

### Year-over Change in Nonfarm Employment in the Greater Sacramento Region, January 2005

	<u>Change in Number</u>	<u>Change in Percent</u>
Greater Sacramento	15,710	1.7
Yuba City MSA	1,300	3.5
Sacramento-Arden Arcade-Roseville MSA	14,100	1.7
Nevada County	310	1.1